Current Issues in Combined Reporting
(Unlocking the Combination)

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I. Introduction

There have been a number of significant developments affecting combined reporting in recent months including final and pending regulatory activity, legislative activity, important administrative rulings, and litigation. Highlights include the final and pending California regulations relating to combined report mechanics, treatment of capital gains and tax credits in a combined report, the "functional test" for business income, and last, but not least, administrative and litigation cases where the *Joyce/Finnigan* controversy is at issue.

II. Overview of the Final Combined Report Regulations

A. In general.

1. The Franchise Tax Board has issued final regulations that deal with the mechanics of combined reporting. The regulations were adopted under Section 25106.5, Rev. and Tax Code are substantially patterned after the procedures and examples provided in Publication 1061, Guidelines for Corporations Filing a Combined Report. However, the mechanics of combined reporting are now reflected in words and phrases, rather than numbers and schedules.

2. Because the regulations generally conform to combined reporting practices already in existence, the regulations apply retroactively.

3. The regulations are part of an expected series of regulations dealing with combination. The regulation consists of a main regulation, which will contain the general rules relating to the mechanics of combination and apportionment, followed by a series of special regulations represented in a "dashed" series dealing with narrower situations. For example, the special rules for capital gains are found the 18 California Code of Regulations[1] §25106.5-2.

4. These regulations do not define a unitary relationship. Unity is established under general judicial law standards (e.g., *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472), and the long established regulations in CCR §25120(b). Thus, the combined reporting regulations operate if a unitary relationship or other combined reporting relationship already exists.

[1] Hereafter, unless otherwise indicated, title 18 of the California Code of Regulations will be referred to simply as "CCR."

5. At present, the main regulation contains only definitions. There is a pending regulation notice which will add the apportionment and allocation rules in a combined reporting setting. The hearing for that regulation notice is scheduled for November 19, 1999. However, because those rules also contain rules that address the *Finnigan* issue, they are discussed in greater detail below.

B. Accounting Methods.

1. Under CCR §25106.5-3, each member of the combined reporting group may have its own accounting methods and elections, independent of the other members of the group. However, if two combined reports reflect the same income, the method with respect to the members must be consistent from one combined report to another. For example, assume that some of the members file a common combined report with a parent's group return, Schedule R, R-7. Assume another member cannot join in the group return filing because it is a fiscal taxpayer. Both combined reports reflect the income of Corporation A. The elections used in reporting the income of Corporation A must be computed the same in both sets of combined reports.

2. If the elections are not consistent, the Franchise Tax Board may resolve the inconsistency as necessary or appropriate, taking into account the totality of facts and circumstances. This may result, for example, in the department choosing one of the methods, after consultation with the taxpayer, based on the relative size of the respective members, whether or not the member is a taxpayer, status within the group (e.g., whether parent or subsidiary), etc.

3. There are special accounting election rules for situations where there has been an erroneous exclusion of a member from the combined report group. Generally, if the erroneously excluded member has made a California election on a California return, the member is bound by its California election. If the member is not a California taxpayer but has made a federal election in a U.S. return, that member is also bound by that election.

4. If the erroneously excluded member has no U.S. filing position, the group may elect on behalf of that member to make elections, even if otherwise required in a timely filed return. The regulation encourages the election to be made during the audit examination process, so that mechanical details and substantiation can be worked out. However, the taxpayer may make an application for an accounting election as late as within 60 days of the applicable notice of tax proposed to be assessed (NPA). (Thus, the permissible application period for an election includes the period to file a protest.)

5. Sometimes substantiation of a late election for an erroneously excluded member can be difficult (e.g., LIFO). If the taxpayer intends to contest the

combination, the regulation allows the late election may be made on a protective basis, subject to the final determination that the member should be in the combined report. Thus, substantiation can be deferred, but the taxpayer must maintain its records so that substantiation can be provided later.

C. Fiscalization.

1. Sometimes, the members of a combined reporting group have different accounting periods. In order for business income of the group to be subject to a common apportionment percentage, the income of all of the members must be assigned to a common accounting year. CCR §25106.5-4 provides accounting rules to make that assignment. The income of the respective members is assigned to the accounting year of a member of the group described as the "principal member."

2. In general, the members of the group are allowed to select any member of the combined reporting group as the "principal member," as long as they retain that member as principal member for the succeeding accounting periods. This is a change from the requirements in last year's Publ. 1061, which contained a specific ordering hierarchy for selecting the principal member. The current version of the Publ. 1061 will be updated to reflect the regulation change.

3. If the members have not made a selection of a principal member (e.g., the members did not file on a unitary basis), or have erroneously filed two combined reports with different principal members instead of a single combined report, there are a set of default rules determining which member will be treated as the principal member.

4. Under the default rules, the principal member is generally the highest parent corporation (including a lower tier parent corporation) which is also a member of the combined report group. If no such parent exists, the "principal member" is the taxpayer member of the group with the largest property factor numerator in California. This is a change from the earlier Publ. 1061 requirements, which tied the principal member to the entity expected to have the largest amount of California business and nonbusiness income. That change will also be reflected in the current version of the Publ. 1061.

5. Income is assigned to the principal member's accounting period either by prorating based on the number of months in common with the principal member, or by an interim closing of the books. The interim method is the more exact method, and must be used if the pro rata method causes a material misstatement of income. The requirement to use the interim method will probably be rarely invoked in a fiscalization context if the members of the group remain intact from year to year. That's because the difference will usually be only reflected as a timing

of income. However, a large change in apportionment factors could present a misstatement of income issue.

6. The combined income of the group is then assigned to the individual California taxpayer member through apportionment. At that point, the apportioned income still reflects the principal member's accounting period. Each taxpayer member then must reassign its share of the California source combined report income to the appropriate segments of its income year based on the proportion of months it has in common with the principal member.

D. Interest Offset

1. In general, the combined report mechanics regulations under Section 25106.5 provide that income of each member of a combined reporting group must determine its income and expenses under the Revenue and Taxation Code as a separate legal entity, without regard to the income and expense of the other members. Exceptions to that principle apply on a case-by-case basis by special rule, such as the treatment of capital gains (see discussion below).

2. The interest offset is one such special rule. In general, the interest offset is an ordering rule that requires interest expense to be deducted against certain classes of income in a designated order. Under that ordering rule, interest expense must be first deducted against business interest income, and then against nonbusiness interest and dividends. Thereafter, interest expense is deductible against the class of business or nonbusiness income to which it relates under CCR §25120(d).

3. Case law holds that interest offset requires that interest expense incurred by one legal entity (after application of the offset against business interest income) must be applied against the nonbusiness income of all members of the unitary group, not just the entity incurring the debt (*Pacific Telephone v. Franchise Tax Board* (1972) 7 Cal.3d 522.)

4. To avoid conflict with the judicial rules relating to interest offset, the regulation incorporates those judicial holdings as an exception to the rule requiring a separate determination of income. If a change in the judicial environment occurs, the regulation will automatically incorporate that change. Further work on this portion of the regulation will be deferred until the constitutional review of the interest offset by the U.S. Supreme Court in *Hunt Wesson v. Franchise Tax Board* is completed (see discussion below).

III. Capital Gains

A. Treatment under Final Combined Report Regulations.

1. Capital gains, in general. The Revenue and Taxation Code incorporates a number of Internal Revenue Code provisions, including some of the rules for gains and losses relating to capital assets, Section 1231 (Internal Revenue Code (IRC)) assets, and assets involved in an involuntary conversion. These rules are complex. There are specific rules under which income and losses in each category can be offset. If an overall capital loss results, federal and California laws do not allow current recognition of the loss. For federal purposes, the loss must be carried back for three years or forward for five years. California does not conform to the federal carryback provisions. In addition, California does not provide preferential treatment for capital gains for corporations. Thus, for corporations, the California effect of these rules is limited to requiring a deferral of capital losses.

2. The new CCR §25106.5-2 of the California Code of Regulations sets forth special rules for the treatment of capital, Section 1231(IRC), and involuntary conversion gains and losses in a combined report. These rules supercede prior audit practices that prevented a business capital loss of one member of the combined group from being deducted against the business capital gain of another member unless the member incurring the loss had an overall capital gain. Taxpayers who had audit adjustments based on that practice should now have had those adjustments reversed.

3. Under the new regulation, capital, Section 1231 (IRC), and involuntary conversion gains and losses which constitute business income are applied against each other in the combined reporting process, buy only after apportionment.

4. The steps for the treatment of such gains and losses are as follows:

(a) All capital, Section 1231 (IRC) and involuntary conversion gains and losses are removed from business income.

(b) If necessary, such business gains and losses are fiscalized to the principal member's accounting period. They are then netted within each category without netting across categories. For example, short term business capital gains can be netted with short term business capital losses. However, at this point, business long term losses cannot be netted with business short term gains.

(c) Each category of business gain or loss is apportioned to the respective California taxpayer members using their California

apportionment percentages. If appropriate, those gains and losses are then fiscalized back to the taxpayer's income year.

(d) The taxpayer member then applies the federal netting rules to all of its California source capital, Section 1231 (IRC), and involuntary gains and losses. This includes business and nonbusiness items in those classes. If an overall gain results, the income is added to California source income to subject to tax.

(e) If an overall loss occurs, under the regulation as originally noticed, each member would have carried that loss into their respective California source gains for the succeeding year.

(f) After concerns were expressed by certain members of the business community, the Franchise Tax Board directed that the provision relating to capital loss carryovers should be reserved in the final regulation. Thus, in the regulation as it was filed with the Secretary of State, there is no rule dealing with capital loss carryforwards.

(g) At its July 1999 meeting, the Franchise Tax Board again directed staff to proceed with the capital loss carryover regulation as originally drafted. This regulation will be heard, along with the general apportionment regulations in the main regulation, on November 19, 1999.

B. Legislation to Repeal Conformity to Federal Law

1. Concerns have been expressed regarding the complexity associated with California conformity to the federal capital gain provisions, particularly as it relates to apportionment and combined reporting. As noted above, California does not provide preferential treatment for capital gains, and the only effect of conformity is to require deferral of capital loss.

2. The complexities associated with the combined reporting rules described above are only part of the problem. For taxpayers filing on a worldwide combined reporting basis, conformity to the capital gains system is particularly troubling. That's because foreign entities that are not subject to the jurisdiction of the U.S. do not otherwise capture capital gain information in the form needed to conform to federal law rules.

3. Thus, the taxpayer members of worldwide combined reporting groups are required to obtain special data solely to comply with California law requirements. Thus, a worldwide group must gather information regarding gain and loss activity for short term, long term, Section 1231 (IRC), and involuntary conversions events. Because that data is not usually presented in audited financial statements, the data must be obtained from original source records. Because capital gain events happen

sporadically and unpredictably with a corporate group, these events are not readily subject to sampling and rough approximation.

4. Thus, a requirement to literally comply with the California capital gain provisions could raise concerns relating to burdens on foreign commerce addressed in *Barclays' Bank v. Franchise Tax Board* (1994) 512 U.S. 298.

5. On the other hand, California cannot ignore the capital loss limitation as it relates to foreign-based activity and require it for U.S. taxpayers, as that could be seen as discrimination against domestic commerce.

6. As a result of all of these concerns, staff and industry representatives agreed that repeal of California conformity to the federal capital gain and loss rules was appropriate. Draft legislation was presented to the members of the Franchise Tax Board that would prospectively repeal capital gain and loss conformity for corporations for years beginning in 1999 and thereafter. As proposed, old year capital losses entering into years beginning in 1999 would still be subject to the same capital loss limitations, but losses originally incurred in 1999 and thereafter would not be subject to the federal limitation.

7. The Franchise Tax Board approved that recommendation, and the draft language was forwarded to the legislature, and eventually found its way, perhaps ironically, into a federal conformity bill, AB 1208.

8. However, AB 1208 got stalled in the legislature, and did not pass. However, because next year is the second year of the legislature's two-year session, AB 1208 is still alive. However, because AB 1208 is a conformity bill, and the capital gain provisions remove conformity to federal law, there is a possibility that the capital gain provisions might be removed from the bill.

C. Pending Issues.

1. The proposed prospective decoupling of federal law does not address industry concerns regarding the residual issues for carryover of capital losses into 1999, nor the treatment of capital losses incurred in earlier years.

2. Some industry representatives have argued that the legislature should retroactively address the problems relating to the treatment of capital gains and losses. A number of proposals have surfaced which would address the issue retroactively. One proposal would have allowed an election to treat all capital losses which are carried into 1999 to be treated as if they were ordinary in the year incurred, but to amortize the tax savings from that treatment as a tax credit over five income years.

3. These alternative proposals were introduced late in the session, and were not adopted in AB 1208. They may resurface in the next legislative session.

IV. Tax Credits

A. Removal of Issue from the Combined Report Regulation Project

1. As originally noticed, the main combined report regulation, proposed CCR §25106.5, would have provided that tax credits are available against the tax liability of the specific member which conducted the creditable activity, unless otherwise provided by law.

2. The regulation was consistent with the department's long standing litigation position that credits earned by one member of a unitary group cannot be applied against the tax liability of another member.

3. The department's position was sustained with respect to solar energy credits in *Appeal of AeroVironment*, 97-SBE-001, Jan. 10, 1997. That position was also sustained in an unpublished summary opinion, *Appeal of Guy F. Atkinson*, Cal. St. Bd. of Equal., Mar. 19, 1997. The taxpayer in the latter case is currently in litigation for the same income years (see discussion below).

4. The department's intention with respect to the language in the regulation was that the phrase "except as otherwise provided by law" would allow the results of the *Atkinson* litigation to be taken into account even after the regulation was promulgated. However, some industry representatives were concerned that the department could use the new regulatory authority in the pending litigation itself.

5. Those industry representatives urged the Franchise Tax Board to exercise its authority under Section 25106.5 to affirmatively *allow* credits to apply against the tax liability of other members of the group. At the direction of the Board, staff met with industry representatives to address technical and mechanical issues regarding industry's proposal.

6. In July 1999, the credit issue was again presented to the Franchise Tax Board. In the past, the California legislature had affirmatively allowed credits to be applied as if the unitary group were "one taxpayer." (See, e.g., former Section 23601(d), Rev. and Tax. Code (1977), subsequently repealed). In addition, Section 23037(g), Rev. and Tax. Code arguably suggests that the default rule for tax credits is that they be allowed in proportion to costs incurred, not as a function of a unitary relationship.

7. Department and legislative staff argued that the legislature had variously applied tax credits on a group or an entity basis, on a case-by-case basis, and that

the issue should be addressed by the legislature, not by a regulatory action of the Franchise Tax Board. As a result, the Franchise Tax Board directed that the main combined report mechanics regulation remove all reference to tax credits, essentially referring the matter back to the legislature and the courts.

8. As noted for hearing on November 19, 1999, the main combined report mechanics regulation stops at the determination of each member's California source income subject to tax, but does not address the computation of tax liability or credits.

B. *Guy Atkinson v. Franchise Tax Board*

1. The former solar energy credit under Cal. Rev. & Tax Code §23601 can only be claimed by the entity that is the "owner" of the property upon which the energy-saving device was constructed. Credit cannot be claimed at the unitary group level, *i.e.*, by other members of the group on an apportioned basis.

2. This is a trap into which numerous taxpayers have fallen, namely, failing to realize that the California credits will be restricted to the taxpayer which is the entity which performed the activities essential to qualifying for the credit, unless a contrary result is mandated by the legislation creating the tax credit. *Appeal of AeroVironment, Inc.*, 97-SBE-001 (Jan. 10, 1997).

3. There is pending litigation in court on this same issue. A trial court decision upholding the FTB's position was reached in *Guy F. Atkinson Co. v. Franchise Tax Board*, No. 987401 (Cal. Super. Ct. Aug. 17, 1998), appeal filed Cal. Ct. App., (Nov. 11, 1998).

4. The issue is one aspect of the much larger "who is the taxpayer" question which has plagued taxpayers and FTB over the years. The *Joyce/Finnigan/Huffy* matter, discussed at length below, is another application of the question. There are many others. See, for example, Legal Ruling 95-2 (crediting tax payments to individual members of a unitary return when assessments or refunds are necessary); compare FTB Notice 91-5 ("When affiliated corporations have elected to file a single return, the amount of any underpayment of tax and the date from which an additional 2% interest applies will be determined with reference to the combined underpayment of all corporations included in that return") with FTB Notice 98-6 reversing Notice 91-5 ("the 2% additional interest under §19104 is required to be determined with respect to the underpayments of each taxpayer member, reflected by means of intrastate apportionment").

V. *Joyce* Method of Apportionment

A. Background[2]

1. When computing the numerator of the sales factor, the taxpayer's California sales must be determined. Sales of tangible property generally are assigned to California if the property is delivered or shipped to a purchaser in California. Cal. Rev. & Tax. Code § 25135(a). However, if a taxpayer is not subject to tax in this State, that taxpayer's California sales generally are "thrown back" to the state of origin, and not treated as California sales. Id.; Cal. Code Regs. tit. 18, § 25135(a)(6). (This rule is commonly referred to as the "throwback rule.") Thus, if goods are shipped from outside California to a purchaser in this State, and if the taxpayer is not taxable here, the sales are "thrown back" to the state of origin and are not included in the numerator of the California sales factor.

2. A taxpayer may have California sales, but not be taxable in California because of Public Law 86-272 or because of Constitutional limitations on California's taxing jurisdiction.

B. *Appeal of Joyce, Inc*., [1966-1971 Transfer Binder (Part 2)] Cal. Tax Rptr. (CCH) ¶ 203-523 (Nov. 23, 1966), and FTB Legal Ruling No. 234.

1. From 1966 through May 1990, the administrative practice of the FTB followed the method of apportionment set forth in *Appeal of Joyce* and FTB Legal Ruling No. 234. *Joyce* held that when a member of a unitary group is immune from tax in California under Public Law 86-272, the California sales of that corporation had to be excluded from the numerator of the California sales factor, even if another member is taxable in that state. This has come to be known as the "*Joyce*" rule.

2. In *Joyce*, the taxpayer was engaged in the manufacture and sale of shoes subject to tax in California. The taxpayer's parent corporation, U.S. Shoe Company, also manufactured shoes and sold them into California, although U.S. Shoe was protected from California's taxing jurisdiction by Public Law 86-272. On audit, the FTB determined that the taxpayer and U.S. Shoe were engaged in a unitary business and combined their incomes for apportionment purposes. In *Joyce*, the FTB included the California sales of U.S. Shoe in the sales factor numerator of the taxpayer's combined apportionment formula.

3. The taxpayer argued that the inclusion of U.S. Shoe's California sales in the numerator of the taxpayer's California sales factor resulted in taxation of

[2] The authors wish to thank Edwin Antolin of Morrison & Foerster for permission to draw heavily from an outline of his for the discussion of *Joyce/Finnigan/Huffy*.

immune income because California was unable to subject U.S. Shoe to California's taxing jurisdiction under Public Law 86-272. On appeal, the SBE held Public Law 86-272 precluded the State from including U.S. Shoe's sales into California ("inbound sales") in the numerator of the sales factor unless U.S. Shoe itself was subject to California's taxing jurisdiction. The SBE stated that even though the FTB was granted the power to apply formulary apportionment, such power was tempered by the taxable status of the taxpayer and other members of the unitary group.

C. *Appeal of Finnigan Corp*., No. 88-SBE-022, [1986-1990 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 401-653 (Aug. 25, 1988), opinion on reh'g, No. 88-SBE-022-A, [Transfer Binder 1986-1990] Cal. Tax Rptr. (CCH) ¶ 401-797 (Jan. 24, 1990)

1. In *Appeal of Finnigan*, the SBE revisited the apportionment rule set forth in *Joyce* in a case involving sales by a California taxpayer to customers outside this State ("outbound sales"). The SBE held that, in the context of such outbound sales, when determining California tax liability, all sales into the destination state by the members of a unitary group should be treated as non-California sales if any member of the unitary group was subject to tax in the destination state, even though the particular selling taxpayer may be immune from tax in the destination state under Public Law 86-272. This had the effect of reducing the California tax for California corporations selling into other states.

2. In *Finnigan*, the taxpayer, and its affiliate, Disc Instruments, both California corporations, sold tangible personal property to other states. Disc was not taxable in those states outside California into which it made sales. The FTB took the position that the sales of Disc should be "thrown back" to California under Cal. Rev. & Tax. Code § 25135(b). The taxpayer argued, and the SBE agreed, that since a member of the unitary group was taxable in the destination state at issue, the sales of Disc were properly assigned to the sales factor numerator of that state, even though Disc was immune from taxation in the destination state under Public Law 86-272.

D. FTB Notice 90-3

1. Following the SBE's opinion on rehearing in January 1990, it still was unclear whether *Finnigan* should be applied, contrary to *Joyce*, to sales into this State by out-of-state sellers not subject to tax in California under Public Law 86-272 or the Commerce Clause (*i.e.*, inbound sales).

2. Later in 1990, the FTB issued FTB Notice 90-3, in which it announced that the *Finnigan* rule would be applied to inbound sales, rather than the *Joyce* rule. Consequently, under FTB Notice 90-3, if any member of a unitary group is taxable in California, the California sales, property, and payroll factors of *all* members of

the unitary group are includible in the numerators of the respective California factors, even if a particular member or members are immune from California taxing jurisdiction.

3. FTB Notice 90-3 further provided that once the California apportionment factor is applied to the group's income, the resulting California apportioned business income is assigned only to those members of the unitary group actually subject to tax in this State. This is so even if the income and factors giving rise to a portion of the income is attributable to a non-taxable member of the group.

E. *Appeal of NutraSweet Co.*, No. 92-SBE-024 [1992-1993 Transfer Binder (Part 2)], Cal. Tax Rptr. (CCH) ¶ 402-524 (Oct. 29, 1992)

1. In *Appeal of NutraSweet*, the SBE revisited the *Joyce* decision and held that the California sales of a Puerto Rico corporation that was immune from California tax under Public Law 86-272 could be assigned to the numerator of the California sales factor of a unitary group, where at least one member of the group was taxable in California. Unlike *Finnigan*, which had addressed "outbound" sales, *NutraSweet* squarely addressed the treatment of "inbound sales," *i.e.*, the California sales of a corporation not taxable in California. The *NutraSweet* decision, however, did not consider the intrastate apportionment rule in FTB Notice 90-3 of assigning California apportioned income only to the members of the group actually taxable in California.

F. *Brown Group Retail, Inc. v. Franchise Tax Board*¸ California Superior Court, County of Los Angeles, No. C714010 (Oct. 8, 1993), rev'd 44 Cal. App. 4th 823 (1996).

1. This was the first court case to consider the *Joyce*/*Finnigan* controversy. At trial, the judge ruled that the *Finnigan* rule violated Public Law 86-272. In this regard, the judge wrote:

"It is the feeling of this Court that the SBE was disingenuous when it stated that *Finnigan* II was only a change in an apportionment rule and did not 'alter in any way the existing rules concerning a state's jurisdiction to tax a particular corporation.' The various mathematical models clearly demonstrate that under the guise of mere apportionment, the state is doing what Congress said it cannot do in P.L. 86-272. The State cannot do indirectly what it should not do directly."

2. However, on appeal, the court did not reach the *Joyce/Finnigan* issue. The court reversed the trial court decision, determining that the taxpayer's activities in California were not immune under Public Law 86-272. Thus, since the taxpayer was subject to tax in California, it was required to include its California sales and payroll in the numerator of its California factors.

G. FTB Reaction

1. In late 1997, in an unprecedented step, the three member board of the FTB (the "FTB Board") authorized the staff to present two versions of proposed regulation 25106.5, dealing with rules for filing combined returns, for public consideration. One version adopted the *Joyce* rule and the other adopted the *Finnigan* rule. After public symposium and comment, the Board approved going forward with the *Joyce* rule.

2. In September 1998, the FTB staff released proposed regulation 25106.5 with language adopting the *Joyce* rule. Then, in December 1998, the FTB Board decided to delay adoption of the *Joyce* rule contained in the proposed regulation, pending the decision of the State Board of Equalization in *Appeal of Huffy*. At the Board's direction, staff removed all of the apportionment rules from the proposed regulation, including the language adopting the *Joyce* rule, and registered the rest of the regulation in July 1999.

3. On March 23, 1999, the FTB Board, without waiting for the SBE to rule in *Appeal of Huffy* (which was decided on April 22, 1999) directed the FTB staff to proceed with the *Joyce* version of the proposed regulation. Soon after that decision, the SBE decided *Huffy*. In that case, the SBE also adopted the *Joyce* rule, effective for tax years beginning on or after the date of that decision. Since the effective date of the *Joyce* rule as directed by the SBE in *Huffy* and the effective date of the *Joyce* rule as directed in the proposed regulation did not match, at the July 1999 meeting of the Franchise Tax Board, the FTB staff advised the FTB Board of the need to conform the effective dates.

4. Pursuant to the Board's direction on March 23, 1999, a new regulation project, which will adopt the *Joyce* version of the regulation, has been officially noticed for hearing. The regulation will adopt the same effective date as the *Huffy* decision, i.e., income years beginning on or after April 22, 1999. (That means that calendar year 1999 taxpayers will still be using the *Finnigan* rule). As noted above, the hearing date for the regulation is November 19, 1999. The regulation also reinserts the basic mechanical rules of apportionment for combined reporting groups, as reflected in the September 1998 version of the regulation.

H. *Appeal of Huffy* - State Board of Equalization, (SBE, Apr 22, 1999)

1. California seems to have come full circle with the SBE's April ruling in *Appeal of Huffy*. In *Huffy*, the SBE decided to overrule its opinions in the *Finnigan* and *NutraSweet* cases regarding the proper determination of the numerator of the sales factor for unitary businesses, returning instead to the rule set forth in the *Joyce.*

2. FACTS*:*

(a) Huffy Corp., an Ohio corporation, was part of a unitary group of corporations. It had two operating divisions, Huffy Bicycle Co. and Huffy Sports Co. It was also the parent company of five active wholly owned subsidiaries.

(b) Huffy filed a combined franchise tax report for each year at issue and was subject to worldwide combined reporting. In determining its combined sales factor for the relevant years, Huffy excluded sales to California customers by it, its two operating divisions, and its consumer products divisions from the numerator. In doing so, Huffy relied on the ruling in *Joyce*. That is, if the out-of-state seller was immune from taxation in California under P.L. 86-272, the sales relating to that activity is not includible in the California sales-factor numerator; the numerator of the sales factor should be limited to sales of members of the group that are subject to California's taxing jurisdiction.

(c) The FTB did not contest Huffy's assertions that it lacked traditional nexus with California.

3. ISSUE: Inbound Sales Case --- Whether the California sales of Huffy, its operating divisions and its consumer products subsidiaries were includible in the numerator of the California sales factor.

4. SBE's Holding

(a). The SBE agreed (at least prospectively) with the taxpayer to revert to the reasoning in *Joyce*.

(b) The logic of the opinion is premised, in part, on strict legal doctrine, and, in part, on what one commentator has characterized as a "follow the leader" mentality.

(c) The SBE acknowledged that while there were "theoretically good" reasons for the initial implementation of the *Finnigan/NutraSweet* rule, "the actual practice has resulted in the taxation of income which would not otherwise be taxed by the State of California." Of note, at footnote 10 of the opinion, the SBE said "the application of [the *Finnigan*] principle as applied by the Franchise Tax Board in Legal Notice 90-3 has resulted in income properly apportionable to a corporation protected by Public Law 86-272 being improperly taxed by California." However, that footnote was later deleted on petition for rehearing (see discussion below).

(d) In addition, the SBE stated that a key factor in reversing the *Finnigan* doctrine is that most other state taxing authorities did not go along but retained the *Joyce* rule. That produced the following results:

California-based sellers that sell into other states where they are immune from tax as individual corporations (but where affiliates are taxable) will have “nowhere income” because the sales are not “thrown back” to California.

Non-California-based sellers that sell into California where they are immune but their sister entities are taxable will run the risk of being subject to double taxation. (Their home states will treat the sale as assigned there because of the throwback rule, and California will treat the same sales as California-based, on the basis that some member of the group is taxable there.)

(e) The SBE noted in *Huffy* that it is mindful of California Revenue and Taxation Code section 25138, which provides that the Uniform Division of Income for Tax Purposes Act (UDITPA) shall be "so construed as to effectuate its general purpose to make uniform the laws of the states which enact it."

5. Retroactive versus Prospective Effect

(a) Despite finding for Huffy on the substantive issue, the SBE denied Huffy a victory by making its holding prospective only, applicable to those income years beginning on or after the date of the opinion.

(b) Noting that the *Finnigan* rule has been in effect for about eight years and that many taxpayers have planned transactions based on the result in that case, the SBE agreed to make the reversal of *Finnigan* prospective only.

(c) The SBE relied principally on the United States Supreme Court’s decision in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971), to conclude that prospective treatment is proper. *Chevron* set forth the following three factor test: (1) whether the decision established a new principle of law by overruling past precedent; (2) whether retroactive application would further or retard its operation; and (3) whether any inequity would result from retroactive application.

6. Petition for Reconsideration in *Huffy*

(a) Both sides filed petitions for reconsideration.

(b) Huffy asked the SBE to reconsider its prospectivity ruling. In the alternative, Huffy asked the SBE to overrule *NutraSweet* retroactively, but not *Finnigan*, or to make its decision selectively prospective, i.e., applicable to Huffy, but not to others whose cases predate the *Huffy* decision.

(c) The FTB asked the SBE to make a few technical clarifications and to omit footnote 10, which stated that Notice 90-3 resulted in the improper taxation of income protected by P.L. 86-272. Notably, the FTB did not object to the central holding of *Huffy*.

7. Opinion on Petition For Rehearing issued September 1, 1999

(a) SBE decided to deny both petitions for rehearing, but went ahead and amended its original opinion, adopting some of the technical clarification, and omitting footnote 10 (see below).

(b) SBE rejected Huffy's contention that the SBE misapplied California law in making its decision prospective. Huffy had argued that the *Chevron*-test for determining whether to apply a decision retroactively or prospectively was in error; rather, Huffy asserted that the prospective application is appropriate when considerations of fairness and public policy warrant the granting of relief from the hardships imposed by retroactive application of the new law. *See Forster Shipbuilding Co. v. County of Los Angeles* 54 Cal. 2d 450 (1960); *Peterson v. Superior Court*, 31 Cal. 3d 147 (1982); and *Newman v. Superior Court*, 48 Cal. 3d 973 (1989).

(c) SBE also rejected Huffy's argument that the SBE inappropriately usurped a legislative or policymaking function by issuing a prospective decision. In this regard, the SBE determined that when it acts in its quasi-judicial capacity, it has the authority to issue a decision with prospective application when the facts merit such a decision.

(d) SBE also rejected Huffy's contention that the SBE should "selectively" apply its decision to Huffy only on the ground that the selective prospectivity doctrine was rejected by the U.S. Supreme Court in *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993).

(e) SBE also rejected Huffy's contention that the *Joyce* rule could apply to inbound transactions, but not to outbound transactions on the ground that the treatment of both inbound and outbound transactions hinges on the same legal theory and must be resolved in a consistent fashion.

(f) Finally, the SBE considered the FTB's contentions. The most significant change proposed by the FTB was the deletion of footnote 10. Footnote 10 provided in part: "the application of [the *Finnigan*] principle as applied by the Franchise Tax Board in Legal Notice 90-3 has resulted in income properly apportionable to a corporation protected by Public Law 86-272 being improperly taxed by California.". The FTB requested that the footnote be deleted because it indicates that it improperly taxed income otherwise protected from taxation by Public Law 86-272. The department argued that if *Finnigan* and *NutraSweet* were good law for the years prior to the effective date of the decision, and if NutraSweet affirmed the effects of Legal Notice 90-3, then the Board should not both not affirm *NutraSweet* for those years and at the same time undercut its rationale.

(g) The omission of footnote 10 might be considered surprising given that California's taxation of immune income appeared to be one of the cornerstones of the decision. In fact, a reference to such overreaching taxation remains in the body of the original opinion.

8. ORDER - *Joyce* rule applies prospectively to those income years beginning on or after the date of the opinion, i.e., April 22, 1999.

I. Consequences of Return to *Joyce*

1. The return to *Joyce* is a recognition by the SBE that California was out-of-step with most other states with throwback rules, but it may also indicate that the Board was concerned about the effects of taxing income immune from taxation under P.L. 86-272.

2. One consequence is that the return to *Joyce* generally benefits out-of-state corporations and hurts in-state corporations, and encourages "nexus" planning.

J. *Appeal of Wynn's International, Inc*., State Board of Equalization (not to be cited as precedent)

1. FACTS: In this appeal on a claim for refund, the SBE considered whether FTB Notice 90-3 and the *Finnigan/NutraSweet* rule should be applied retroactively to years before the *Finnigan* rule was first announced. In the case, which involved income years ended December 31, 1983 and 1984, appellant was a member of a unitary group. Two members of the unitary group (Lone Star and Bestop) were not taxable in California under P.L. 86-272. In reliance on the *Joyce* rule, the Appellant excluded the California sales of Lone Star and Bestop from the numerator of the California sales factor. Due to a federal audit, Appellant extended the time within which California could issue an assessment for 1983 and 1984. Later, when the *Finnigan* rule was announced and Notice 90-3 was issued, the

FTB adjusted Appellant's sales factor by including the California sales of Lone Star and Bestop in the numerator of the sales factor.

2. On appeal, Appellant argued that it had reasonably relied on the *Joyce* rule at the time it prepared its 1983 and 1984 returns, that the FTB should adhere to the *Joyce* rule for years prior to Notice 90-3, that the FTB improperly applied Notice 90-3 retroactively, and that the rule in Notice 90-3 improperly discriminates against Appellant.

3. SBE holding:

(a) First, the SBE determined that Notice 90-3 was akin to a rule or regulation, and therefore was governed by Cal. Rev. & Tax. Code § 26422, which provides, in part, that the FTB "may prescribe the extent, if any, to which any ruling or regulation shall be applied without retroactive effect." Thus, the SBE concluded that Notice 90-3 applied with retroactive effect since there was not express language to the contrary.

(b) Second, the SBE determined that *Finnigan* should be applied retroactively. In reaching this conclusion, the SBE declared that its decisions would be applied on a prospective basis only when "considerations of fairness and public policy warrant the granting of relief." Otherwise, the general rule of retroactivity should apply. Since the *Finnigan* decision expressed no intent to apply that decision prospectively, the SBE concluded that the general rule of retroactivity should apply to the *Finnigan* decision.

(c) Third, the SBE rejected the Appellant's claim that the rule in *Finnigan* should be "selectively" applied to the case at hand, citing United States Supreme Court decisions that have rejected the selective prospectivity doctrine in judicial cases.

(d)) Finally, the SBE refused to consider Appellant's claim of discrimination on the ground that this argument raised a constitutional question.

4. Comments

(a) Query: is there a reasoned basis for the SBE to apply the *Huffy* case prospectively and to apply the *Finnigan* case retroactively since the considerations of "fairness and public policy" would seem to be similar in both cases?

(b) It is arguable that the consideration of "fairness and public policy" weighed more in favor of a prospective application of the *Finnigan* case because that case marked an unanticipated reversal of a 24 year old rule. By contrast, the *Huffy* case marked the reversal of a relatively short term rule that had been widely criticized, was struck down by the one trial court that considered it, and was the object of many active litigation cases.

K. *Deluxe Corp. v. FTB*, SF Superior Court, Docket No. 991237 (5/26/99)

1. FACTS: This case presents essentially the same issue (i.e., inbound sales) as in *Huffy*. Deluxe and two subsidiaries engaged in a unitary multi-state business. All were domiciled outside California, and only Deluxe was taxable in California. The two subsidiaries, Current and Colwell, were immune from tax in California under P.L. 86-272. The case was tried on stipulated facts.

2. Deluxe argued, in part:

(a) The California sales of Current and Colwell should not be included in the numerator of the sales factor since the method of apportionment set forth in Notice 90-3 results in the circumvention of P.L. 86-272 and the Constitution since California is indirectly taxing income beyond the reach of its taxing jurisdiction.

(b) The apportionment method under Notice 90-3 discriminates against interstate commerce in violation of the Commerce Clause. Deluxe argued that if Current and Colwell are immune from tax in California under P.L. 86-272, its California taxable income increases because the taxable income attributable to Current's and Colwell's sales are assigned to Deluxe. However, if Current and Colwell have nexus with California and therefore are taxable by that state, Deluxe's tax liability decreases because the taxable income attributable to Current's and Colwell's sales are no longer assigned to Deluxe, but rather are assigned to Current and Colwell.

(1) Two identically situated taxpayers, one with affiliates not taxable in California and one with affiliates taxable in California, would have different tax liabilities.

(2) The discrimination lies in the arbitrary assignment of California apportioned income only to the taxable members of the group, not all members giving rise to such income.

(c) The FTB method of apportionment in Notice 90-3 is not fairly apportioned since the second tier apportionment (i.e. intrastate

apportionment) does not "reflect a reasonable sense of how income is generated" because:

(1) The inclusion of the sales of Current and Colwell in the numerator of the sales factor increases the income apportioned to California. (First tier apportionment.)

(2) But, Notice 90-3 directs that the California apportioned income be intrastate apportioned only to Deluxe.

3. HOLDING: The Trial Court held for the FTB, following *Finnigan*.

(a) Held, that the definition of taxpayer (as used in the throwback) provision is broad enough to include all members of a unitary group.

(b) Held, that the method of apportionment under Notice 90-3 does not result in the circumvention of P.L. 86-272, reasoning that it is permissible to take into account the income of non-taxable members for purposes of apportionment.

(c) Held, that the intrastate apportionment method under Notice 90-3 is appropriate because if the income were proportionally assigned, the result would be the same as under the *Joyce* rule.

(d) Held, that the Commerce Clause is not violated. The method of apportionment is fairly apportioned since it is internally consistent. Also, the method of apportionment does not discriminate against interstate commerce when the unitary group is viewed as a whole.

(e) *HUFFY* - The court read *Huffy* as a pragmatic choice between two permissible methods of apportionment to make California consistent with most other taxing jurisdictions.

L. *Citicorp North America Inc. v. FTB*, SF Superior Court, Docket No. 990474 (Statement of Proposed Decision 1/12/99)

1. FACTS: Like *Huffy* and Deluxe, this is an inbound sales case. However, this case does not implicate P.L. 86-272 because Citicorp involved credit card receipts, not sales of tangible personal property.

Citicorp North America, domiciled outside California, and 85 affiliates brought suit claiming, in part, that the California sales of Citibank (South Dakota), a member of the unitary group that issued credit cards to California customers, should be excluded from the sales factor numerator.

2. HOLDING:

(a) Court followed *Finnigan*.

(b) *Finnigan* is most consistent with fundamental unitary business principles that form of business should not matter.

(c) Inclusion of Citibank South Dakota's sales in numerator does not result in unlawful taxation of immune income (because California Supreme Court has already determined that unitary apportionment is not the taxation of extraterritorial income); and is not a disregard of the separate/distinct legal entities.

(d) *Finnigan* does not violate the Constitution since the method of apportionment is internally consistent and is not out of all appropriate proportion to the California activities.

M. *Reader's Digest Association, Inc. v. Franchise Tax Board*, Sacramento, Superior Court, Docket No. 98AS03483

1. Complaint raises the *Finnigan/Joyce* issue as well as whether *Finnigan* violates Public Law 86-272.

2. Discovery is proceeding**.**

VI. Intercompany Transactions.

A. The treatment of intercompany transactions has been a difficult issue, and has been an object of Franchise Tax Board staff study for over 10 years. After numerous conferences and symposiums on the subject, department staff has been authorized to issue

a notice of regulatory hearing on the issue as proposed CCR §25106.5-1. As of this writing, the hearing date is expected to be in December 1999.

B. The details of the regulation are beyond the scope of this outline. In general, the regulation (as reflected in the notice of regulation hearing) will do the following:

1. For the most part, the proposed regulation will conform to the extent possible to the federal rules for treating intercompany transactions contained in Treasury Regulation section 1.1502-13 of the consolidated return regulations. Modifications to the federal rules are provided when necessary to account for differences between federal and state law, such as combined reporting, apportionment, and water's-edge elections. Because the proposed regulation incorporates and builds upon Treas. Regulation section 1.1502-13, the structure and numbering generally follow that Treasury regulation in order to facilitate cross-referencing between the two regulations.

2. In conformity with federal consolidated return treatment, the proposed regulation requires intercompany transactions to be reported in accordance with a matching rule and an acceleration rule.

(a) Essentially, the matching rule provides that intercompany transactions are to be taken into account as if the seller and buyer were divisions of a single corporation. In general, this means that income from an intercompany transaction will not be taken into account until the intercompany asset leaves the unitary group. At that time, any deferred intercompany gain will be taken into account by apportionment, using the apportionment percentages for the same year the intercompany income is taken into account.

(b) The acceleration rule operates to take intercompany items into account when the effect of treating the seller and buyer as divisions of a single corporation cannot be achieved, such as when either the seller or buyer leaves the combined reporting group. Income from an acceleration event is generally taken into account the moment immediately *before* the acceleration event occurs. Thus, deferred gains will be apportioned using the apportionment percentages of the members of the group just before the acceleration event.

(c) This methodology is consistent with unitary theory because it generally results in the deferral of items of income, gain, deduction and loss from intercompany transactions until such time as there is an economic effect to the unitary business as a whole.

3. The most significant California modifications to the federal treatment of intercompany transactions are as follows:

(a) Apportionment. Federal income tax rules do not include rules of geographic apportionment, which are required for state corporate income and franchise taxation. Consistent with the approach that intercompany transactions are taken into account as if the seller and buyer are divisions of a single corporation, intercompany sales events will not generally have an effect on the apportionment factors. Intercompany items are treated as current apportionable business income in the period in which they are taken into account.

(b) Acceleration rule triggered by conversion to nonbusiness use. Federal income tax rules do not include the concepts of business and nonbusiness income, which are included in the Uniform Division of Income for Tax Purposes Act, as adopted and contained in sections 25120 through 25141 of the Revenue and Taxation Code. If an asset that was the object of an intercompany transaction is converted to a nonbusiness use, then it is no longer part of the unitary business operations. Therefore, any intercompany gains attributable to that asset will be taken into account under the acceleration rule immediately before the nonbusiness conversion.

(c) Intercompany distributions.

(1) Federal income tax law for commonly owned businesses include joint liability for consolidated return members and elective filing rules that are not part of the Revenue and Taxation Code. Although the draft regulation generally applies the provisions of Treas. Regulation section 1.1502-13(f) relating to stock of members, the federal rules will not be applied to intercompany dividend distributions. Intercompany dividend distributions are included in the income of the distributee member unless subject to elimination or deduction under other applicable sections of the Revenue and Taxation Code, including sections 25106 and 24402.

(2) California does not conform to Treas. Regulation section 1.1502-32 relating to investment adjustments to the basis of the stock of a subsidiary, or to Treas. Regulation section 1.1502-19 relating to excess loss accounts. However, the proposed regulation provides for a "deferred intercompany stock account" which will operate in a manner similar to the federal excess loss account for the limited purpose of deferring gain from intercompany distributions which exceed the payer’s earnings and profits and stock basis.

(d) Entering or withdrawing from the state. An objective of the draft regulation is to minimize state-only recordkeeping by conforming as closely as possible to the federal treatment, thus making it more likely that intercompany items will be taken into account in the same period for state purposes as for federal purposes. In furtherance of this objective, taxpayers which enter the state will bring deferred intercompany items with them as if this regulation had been applied in the year of the intercompany transaction. Likewise, taxpayers which withdraw from the state will take their intercompany items with them, and no acceleration will be applied to capture that income within the state. This is consistent with the divisional analogy of the matching rule.

(e) Partially included water's-edge entities. California law includes a "water's-edge election" which has no federal counterpart. Rules are provided to clarify the application of this proposed regulation to corporations which are partially included in a water's-edge combined reporting group under Revenue and Taxation Code sections 25110(a)(4) and 25110(a)(6). These rules will supercede the rules currently stated in Cal. Code Regs. §25110(e) for eliminating intercompany accounts between entities included in a water's-edge combined reporting group.

(f) Foreign country operations.

(1) For purposes of determining the tax, California law requires the inclusion of the income and apportionment factors of unitary entities organized in foreign-countries in a combined report (see *Barclays'*, supra). Federal law generally excludes such entities. Thus, reasonable approximations will be permitted in order to minimize the compliance burden for foreign corporations that are not required to follow a similar deferral system for federal income tax or any other purposes.

(2) Such corporations may report intercompany transactions using the method used for consolidated financial reporting purposes as long as that method reasonably reflects income and approximates the result that would be obtained by using the rules in the proposed regulation. Adjustments may be permitted or required for any material transaction or series of transactions if the financial reporting method does not produce a result that reasonably approximates the results under the proposed regulation.

C. Changes from prior versions and other significant issues.

1. Major change in composition of the group.

(a) Earlier versions of the regulation, made available to the public and the department's web site and reviewed in symposium, would have provided a special acceleration rule in the event that any portion of the group to which the seller and buyer belong constituted less than 60% of the former combined reporting group. In that case, the change to the group was considered so extreme that the acceleration rule was to be applied to take intercompany items into account.

(b) That rule has been dropped from the latest version of the proposed regulation. The new version allows intercompany items to continue to be deferred, so long as the buyer and seller and the asset remain in the same unitary group. Because this rule can result in potential manipulation, gain can nevertheless be accelerated under an anti-abuse rule.

2. Consideration of an elimination and basis transfer system. In symposium, staff was asked to consider an elimination and basis transfer system in lieu of the deferred income system. After review, staff recommended against that alternative, principally because it would create serious across-the-board nonconformity with the federal consolidated rules, but also because it could present California with the same problems that the Treasury was faced with when it abandoned an elimination and basis transfer system in the consolidated return regulations in 1966.

3. Distribution rules. The latest version of the regulations retains the nonconformity to the federal rules for distributions between members of a consolidated return group. In general, the California regulation does not treat a distribution in excess of basis (Section 301(c)(3), IRC) as if it were negative basis, as is the case under the federal consolidated return Excess Loss Account rules. Instead, the California rule simply treats the distribution as deferred income. In most cases, the state income result will be the same as the federal treatment, except in cases where the federal basis rules would cause the negative stock basis to be disregarded, as, for example, in the case of a liquidation of the stock of an 80% held subsidiary (Section 332, IRC).

VII. Elective Combination Déjà vu.

A. For several years now, the legislature has entertained the idea of elective combination. As proposed, under elective combination, all members of the commonly controlled group of corporations (Section 25105, Rev. and Tax. Code), would elect to be included in the same combined reporting group for a minimum period of ten years, whether or not they are unitary under traditional unitary standards.

B. This approach has been considered attractive, because the problems associated with making a unitary determination can be burdensome. With the application of

combination based on strong central management and centralized departments (CCR §25120(b)(3); *Mole-Richardson v. Franchise Tax Board* (1990) 220 Cal.App.3d 889; *Dental Insurance Consultants v. Franchise Tax Board* (1991) 1 Cal.App.4th 343; c.f. *Tenneco West v. Franchise Tax Board* (1991) 234 Cal.App.3d 1510), the unitary inquiry could, in theory, be a fairly invasive inquiry into sensitive management communications and philosophy.

C. This year was no exception. Two bills were introduced which would have provided for elective combination, SB 304 and SB 1015.

1. SB 304 would have applied only to regulated public utilities.

(a) These entities have had difficulty asserting a case for strong central management with department auditors because of regulatory "firewalls" of the Public Utilities Commission which limit certain contacts between the utility and non-utility members of the commonly controlled group.

(b) As proposed, this bill would have allowed elective combination for all members of the public utilities' commonly controlled group. This bill also contained a purportedly "bright line" unitary standard for nonelecting utilities. In general, combination would be allowed only if certain functional transactions are present (intercompany sales, common customer base, technology transfers, common distribution systems, etc.) or if a day-to-day management threshold were satisfied, a higher threshold than the current "strong central management" standard.

2. SB 1015 would have applied to all taxpayers. As originally introduced, the bill would have provided for elective combination without effect on nonelecting taxpayers. However, subsequently the bill was amended to include the same "bright line" standards for non-electors as was present in the utility bill.

3. Both bills never made it past their house of origin. There are two basic factors that affect the passage of elective combination bills. The first is revenue. In general, these bills result in revenue losses in excess of $20 million per year. Second, the legislature is reluctant to address the issue of elective combination, and incur that revenue loss, without also trying to cure the general uncertainties of the unitary determination.

VIII. Interest Offset

A. Rev. & Tax Code Section 24344

1. Section 24344 allows interest expense (unless otherwise limited by other provisions of the Code) to be deducted in arriving at net income. Rev. & Tax Code

Sec. 24344(a). However, contained within the statutory section are interest offset rules. The rules require that interest expenses be allocated into different categories.

(a) First, interest expense incurred by a corporate taxpayer is deductible to the extent of business interest income. Reg. 25120(d)

(b) Second, the excess interest expense is then directly offset against any nonbusiness interest and dividend income. Dividends that are deductible because paid out of earnings previously taxed by California, intercompany dividends between unitary entities that are excluded from gross income, and dividends deductible under Rev. & Tax Code Sec. 24411 (water's-edge electors) are not included in this computation. Rev. & Tax Code Secs. 24434(b), 24402 and 25106. The amount, which is allocated to non-business interest and dividends, constitutes the interest offset.

(c) Any remaining interest expense is deductible under Section 24344(a). The Franchise Tax Board then applies CCR Section 25120(d) to allocate remaining interest expense against business and nonbusiness income.

2. See discussion above regarding the treatment of the interest offset in Reg. Section 25106.5.

B. *Pacific Telephone and Telegraph v. Franchise Tax Board*

1. The issue presented in *Pacific Telephone and Telegraph v. Franchise Tax Board*, 7 Cal. 3d. 544, 102 Cal. Rptr. 782 (1972), was whether the phrase "interest and dividend income…not subject to allocation by formula " as an offset against interest deductions under Rev. & Tax Code Sec. 24344(b) should be applied to reduce the interest expense of a unitary business when that business received deductible dividends from affiliated companies.

2. The court concluded that such intercompany dividends should be included in the phrase. In so concluding, the court rejected Pacific Telephone's argument that only taxable intercompany dividends were to be included in the subject phrase.

3. The court found that dividends are income whether or not taxed. Further, the interpretation that nontaxable dividends should be offset against interest deductions was appropriate to close a potential loophole whereby a foreign corporation could increase its borrowings to create a deduction and use the loan proceeds to buy stocks which would create nontaxable dividend income. 7 Cal. 3d at 554.

4. The court however, never specifically addressed nor analyzed the constitutional issues, which resulted from its interpretation of Rev. & Tax Code Sec. 24344(b).

C. *Hunt-Wesson, Inc. v. Franchise Tax Board*

1. The *Hunt-Wesson* case raises the issue of the constitutionality of Rev. & Tax Code Sec. 24344(b), which was not raised in the *Pacific Telephone* case.

2. Hunt-Wesson (a successor in interest to a number of other entities) was a diversified corporation engaged in the food products business both within and outside California. The corporation owned a number of dividend-paying subsidiaries that were neither incorporated in California nor unitary with Hunt-Wesson. During the fiscal years ending February 1980 through 1982, Hunt-Wesson received dividend income from these affiliates and characterized that income as non-business allocable to Illinois. The Franchise Tax Board, in accordance with Rev. & Tax Code Sec. 24344(b), disallowed interest expense deductions on a dollar for dollar basis.

3. Hunt-Wesson filed a claim for refund arguing that the provisions of Sec. 24344(b) violate the Due Process, Commerce and Equal Protection Clauses of the U.S. Constitution.

4. The Superior Court found the holding in *Pacific Telephone* not controlling on the grounds that it did not address the constitutional issues. The court, after analyzing the statute in light of several U. S. Supreme Court decisions, held the dollar-for-dollar offset without regard to whether or not such interest is related to the dividend income violates the Due Process Clause. The court further held that the statute discriminates against interstate commerce in violation of the Commerce Clause because the statute treats two identical corporations differently based solely on their state of domicile. Finally, the court found the statute precluded interest deductions to the extent of nontaxable income irrespective of whether those deductions were related to the nontaxable income. As a result, the statute also violated the Equal Protection Clause. The statutory provisions were applied unequally to domestic and foreign corporations because only the dividend income of the foreign corporations is nontaxable in California. Thus, the purported state purpose is discriminatory and not rationally related to a legitimate state purpose. Superior Court of San Francisco County No. 976628, June 6, 1997.

5. The Court of Appeals reversed the holding of the Superior Court. In so doing, the Appellate Court relied on the holding in *Pacific Telephone* that the inclusion of nontaxable dividends in the interest offset computation did not result in the taxation of the dividends themselves. The Court concluded that the facts in Hunt-Wesson were not distinguishable from those set forth in *Pacific Telephone*.

The Appellate Court rejected Hunt-Wesson's Commerce Clause argument concluding that the argument collided with the holding in *Pacific Telephone* that the interest offset provisions are not a tax on dividends. Here the Court found that the alleged favorable effect on local commerce is indirect and incidental and does not rise to the level of facial discrimination. The Appellate Court concluded that in absence of a directly applicable ruling by the U.S. Supreme Court holding unconstitutional an interest offset provision like that in issue the Court is bound by the California Supreme Court holding in *Pacific Telephone. Hunt –Wesson, Inc. v. Franchise Tax Board*, No. A079969, December 11, 1998. Petition for Review denied by Cal. Supreme Ct., March 24, 1998.

6. Petition for Writ of Certiorari granted September 27, 1999, No. 98-2043

IX. Business Income

A. The Business Income Tests

1. The allocation and apportionment provisions of UDITPA, which most states adopt either in whole or in part, define apportionable "business income" and allocable "nonbusiness income" as follows:

> (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
>
> ***
>
> (d) "Nonbusiness income" means all income other than business income.

2. Rev. & Tax Code Sec. 25120(a), and (d), respectively, adopt the language of UDITPA for purposes of defining business and nonbusiness income.

3. The "business income" definition has generated controversy over whether it contains only a "transactional test," derived from its first clause, or whether it also includes an independent, alternative "functional test," derived from its second clause. Although UDITPA is a uniform act, there are state court decisions on both sides of the controversy.

4. Generally, under the transactional test, the focus is on the nature, frequency, and regularity of an income-producing transaction in relation to the taxpayer's

regular trade or business. The frequency or regularity of an income-producing transaction is a critical factor under this test.

5. Under the functional test, the focus is on the function of, or the relationship between an income-producing asset and the taxpayer's regular trade or business operations. In those states that adopt a functional test analysis, the frequency or regularity of an income-producing transaction is irrelevant for purposes of this inquiry.

B. The Functional Test – California Decisions

1. The majority of courts and state tax authorities that have considered the question have concluded that the UDITPA "business income" definition contains both a transactional test, and an alternative functional test. If an item of income is classified as business income under either of these tests, the income is subject to apportionment in jurisdictions embracing the view that the UDITPA definition in fact contains two separate tests.

2. In an early case considering this issue, the California State Board of Equalization also recognized that the UDITPA income classification scheme embodies both a transactional and a functional test. In *Appeal of Borden Inc.*, SBE-XXII-21, 77-SBE-007 (1977), the Board ruled that the loss from the sale of a corporate division was apportionable to California under the functional test. Borden operated numerous dairies, creameries, and ice cream companies in California. Because of a decline in profitability in its California operations, Borden sold at a loss all the tangible and intangible assets of its business in the state.

(a) The Board first analyzed the concept of "unitary income" under its own prior rulings. Under its prior rulings, the Board noted, income from tangible or intangible property was considered apportionable unitary income if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations. Further, according to an earlier Board ruling, the underlying principle [of the unitary income concept] is that any income from assets, which are integral parts of a unitary business, is unitary income.

(b) The Board noted that it is therefore appropriate that income from property, which is developed or acquired and maintained through the resources and in furtherance of the unitary business, should be attributed to the business as a whole. The Board then observed that California's business income statute (taken from UDITPA) was patterned after the Board's prior rulings and concluded that the continuity between those

rulings and the uniform act supports the argument that the statute embodies a functional test.

(c) Next, the Board focused on the MTC regulation, adopted by California, which provided that gain or loss from the sale, exchange, or other disposition of real or tangible or intangible property constitutes business income if the property while owned by the taxpayer was used to produce business income. According to the Board, this regulation fortified the conclusion that the uniform act "clearly adopts the functional rather than the transactional test for business income."

(d) Applying the functional test to Borden's disposition of its California assets, the Board found that the intangible goodwill Borden sold was undeniably an important asset in Borden's business and contributed materially to the production of business income. The Board found unpersuasive Borden's argument that the goodwill was not a unitary business asset because Borden never claimed any depreciation or other deductions with respect to the intangible property. As a result, the Board ruled that loss from the sale of the goodwill was apportionable to California.

3. In *Appeal of PQ Corp.*, Cal. SBE No. 95A-0884 (October 9, 1997), tax authorities in California reiterated their position that the UDITPA scheme contains both a transactional and a functional test. In this case, the State Board of Equalization ruled that dividends received from non-unitary subsidiaries were nonbusiness income under the functional test, and that capital gains from the sale of mineral leaseholds were business income.

(a) PQ Corporation is a manufacturer of siliceous chemical products. It owns 45% of Sidesa, a Mexican corporation that was a joint-venture established to secure a steady Mexican customer for its licensed technology, expand its operations into Mexico and spread its business risks over a greater geographical area. PQ Corporation also owns a 48% interest in PQP, a Colombian corporation, which it owned to expand into the Colombian market and spread its business risks. Both companies maintained their own separate management, sales force, and engineering a administrative personnel. Although there were some intercompany sales between Sidesa and PQ Corporation, they represented less than .1% of PQ's sales and .5 % of Sidesa's total purchases.

(b) The Board begun its analysis by noting that the UDITPA definition of business income involves both a transactional test and a functional test. PQ Corporation argued that its ownership interests in Sidesa and PQP were mere investments and were not functionally integrated parts of their business operations. Applying the functional test, the Board found that the stock holdings did not become an integral part of the taxpayer's business and that "mere potential is insufficient to support a finding that the gains on these [stock] sales were business income under the functional test." Based on these findings, the Board concluded that the dividends received were properly characterized as allocable nonbusiness income.

(c) The Board reached the opposite conclusion with respect to the capital gains. The Board determined that the factual record was insufficient to support a finding that the gain on the sale of the mineral leaseholds was business income under the functional test. Rather, the Board concluded it was business income under the transactional test. PQ Corporation sold the mineral leases to Texas Gulf for the right to purchase soda ash (an essential raw material used in PQ Corporation's manufacturing operations) at a discount for 25 years. Thus, the Board reasoned, because the sale secured a long-term, cost-effective supply of soda ash, the capital gains plainly arose in the regular course of the taxpayer's business and therefore constituted apportionable business income under the transactional test.

4. The California Appellate Court recently examined the "business income" definition in *Robert Half International, Inc. v. Franchise Tax Board*, No. A079671 (September 21, 1998), when it ruled that a corporation's loss constituted an allocable nonbusiness item under the functional test. At the time of the events preceding this case, Robert Half International Inc. was known as Boothe Financial Corp. In January 1980, Boothe acquired in a statutory merger the assets of an entity known as the IDS Realty Trust. Following the merger, Boothe's principal business was real estate development and the leasing and sale of computer and other equipment. Under the terms of the merger, Boothe assumed the obligation to issue its own shares under a warrant that was held by a third party, Investors Diversified Services Inc. ("IDS"). As a result of the merger, the warrant became a right to purchase 480,000 shares of Boothe. Subsequently, IDS transferred the warrant to its parent, Allegheny Corp. Boothe's shares were publicly traded, and Boothe's chairman and CEO believed that the existence of the warrant had an unsettling effect on the market for Boothe's shares because the owner could, by exercising it, own a substantial and perhaps controlling interest in the company. Accordingly, in February 1981, Boothe paid Allegheny $7.5 million to repurchase and cancel the warrant.

(a) On its 1981 corporate franchise return, Boothe deducted the entire $7.5 million payment as a nonbusiness loss within the meaning of Rev. & Tax Code Sec. 25120(d). The FTB asserted it was a business loss to be apportioned, and not allocated, to California. The trial court ruled for the FTB. The parties agreed both that the business income definition contained two separate tests, and that the loss at issue did not qualify as a business loss under the transactional test. Thus, as the court stated, the pivotal issue was whether, under section 25120(a), the loss Boothe incurred when it repurchased the warrant arose from "tangible or intangible property…the acquisition, management, and disposition of which constituted an integral part of its regular trade or business operations." With respect to this question, the court stated that: "Clearly the answer is no."

(b) The court determined that Boothe's purchase of the warrant was motivated by an extraordinary event that was outside the scope of its regular business activities. In so holding, the Court of Appeal relied upon *Phillips Petroleum v. Dept. of Revenue* (Iowa) 511 N.W.2d 608 (1993), which had held that sale of oil and gas properties to fend a take-over attempt was an irregular, extraordinary event and therefore not part of the taxpayer's "regular" trade or business. Under the clear language of section 25120, subdivisions (a) and (d), the loss Boothe incurred thus constituted nonbusiness income, the court concluded. Accordingly, the court reversed and remanded the judgment of the trial court.

(c) After the Court of Appeal's decision, the FTB petitioned for rehearing. Although the court denied the petition, it did add footnote four, which placed two significant limitations on the decision. First, the court stated that because the issue was not presented in the case, "we express no opinion on whether income that arises when a taxpayer sells property that it used in its *regular* or business operations should be characterized as business or nonbusiness." (Emphasis added.) Second, the court stated it expressed no opinion "on the corollary rule that is applied in states that have adopted the latter position: *i.e.*, that the infrequency or extraordinary nature of the sale is irrelevant."

5. The Superior Court of Sacramento County has also addressed the issue of whether there is an alternative and independent functional test for characterizing business income. *Hoechst Celanese Corporation v. Franchise Tax Board*, No. 96AS01954 (July 30, 1998).

(a) Hoechst Celanese ("Celanese") is a Delaware Corporation with its principal place of business in New Jersey. The corporation is engaged in the manufacture and sale of a diversified line of chemicals. In 1947, the company established its first defined benefit pension plan for its employees.

The plan was part of the employee compensation plan and was administered through a trust. Pursuant to the terms of the trust, the investment manager had exclusive authority to manage, acquire and dispose of any assets. Celanese made contributions to the plan based on actuarial computations. The contributions were deducted as ordinary business expenses in arriving at California apportionable income.

(b) Due to a change in investment strategy in the late 1970's the plan developed a large investment surplus. In 1983 the Board of Directors chose to effect a reversion and terminate the plan. After receiving government approval to terminate the plan, Celanese received $388.8 million. This amount represented the Trust assets in excess of liabilities. The pension reversion funds were used by Celanese to carry a stock redemption program.

(c) Celanese initially characterized the income as business income. Subsequently, the company amended its 1985 return to re-characterize the income as non-business income and seek a refund. The Franchise Tax Board denied the refund request.

(d) The issues presented to the Superior Court were whether the pension reversion income was business income as defined by Rev. & Tax Code Sec.25120 and whether the taxation of such income was constitutional.

(e) The court first addressed the issue of whether the statute contained a separate functional test and concluded the definition of business income under Sec. 25120 provides for two alternative independent tests to classify business income. The court then went on to apply the two tests.

(f) The transactional test requires that the gain/income arise from transactions and activity in the regular course of the taxpayer's trade or business. After reviewing the historical basis for terminating the plan, the court concluded that the reversion did not arise as a part of Celanese's regular trade or business.

(g) The court however, found the evidence presented in the case established that the plan was established for the benefit of its employees as part of the compensation package. Further, although the investments were held in trust the plan provided that any excess funds would revert to the company. Thus, the court concluded that the pension plan was established and acquired by Celanese as an integral part of its regular business operations. In so concluding the court rejected Celanese's argument that the reversion represented a once-in-a-corporate lifetime event and as such was not a disposition which constituted an integral part of the company's trade or business operations.

(h) The court also rejected the constitutional arguments put forth by Celanese. Because the pension plan constituted an integral part of the business operations the plan clearly served an operational function. Thus, business income treatment fell within the holding of the U.S. Supreme Court in *Allied Signal, Inc. v. Director, New Jersey Division of Taxation*, 504 U.S. 768 (1992).

(i) The case is on appeal to the California Appellate Court.

6. Compare the Superior Court's decision with that of the North Carolina Appellate Court in *Union Carbide Corporation v. Offerman*, N.C. Ct. of App. No. COA 97-956 (April 6, 1999).

(a) Since 1951, Union Carbide maintained a pension plan for its employees. The plan was funded by contributions made from the company's general business earnings. In 1984, in response to a threat of a hostile takeover, Union Carbide adopted a restructuring plan. As part of that plan, Union Carbide effected a revision of the pension funds consistent with the terms of the federal statutes. The company received $500,000,000 from the pension plan's assets. The funds were used to re-purchase 56% of the company's stock.

(b) Union Carbide on its North Carolina corporate income tax return characterized the funds received as a result of the pension reversion as non-business income allocable to Connecticut its corporate domicile. The State argues that the reversionary income is business income because the income was derived from intangible property, *i.e.* the pension plan, which was operated and managed as an integral part of Union Carbide's business operations. Union Carbide argued the pension reversion was an extraordinary event and thus the income was properly characterized. The Superior Court granted Summary Judgment in favor of Union Carbide.

(c) The Appellate Court, affirming the Superior Court, reasoned that the pension funds were not income to Union Carbide until they were removed. Thus, based on this rationale the court concluded the income in issue arose not from the operation of the plan but from the reversion of excess pension funds. The Appellate Court found this to be an extraordinary event rather than an integral part of the business operations.

(d) This case had been remanded to the Court of Appeals from the North Carolina Supreme Court to be reconsidered in light of the state supreme court's decision in *Polaroid v. Offerman* 507 S.E.2d 284 (1998) holding that there were two distinct test for determining the characterization of income, and that an extraordinary event did not prevent business income

treatment (see discussion below). On May 11, 1999, the state gave notice of its appeal as of right to the state supreme court. Oral arguments are scheduled for January 2000.

C. The Functional Test – Non-California Decisions

1. In one of the first cases to analyze the issue in depth, the District of Columbia Court of Appeals held that the second clause of UDITPA's business income definition provides an alternative, functional test. *In District of Columbia v. Pierce Associates, Inc.*, 462 A.2d 1129 (1983), the court ruled that insurance proceeds received for flood damage to the taxpayer's manufacturing plant were apportionable business income under the functional test.

(a) Pierce was a mechanical contractor in the business of furnishing and installing plumbing, heating, air conditioning, and air ventilation systems. It also owned a manufacturing plant where it produced sheetmetal ducts, automatic sprinklers, and other specialties for use in its contracting business.

(b) As an initial matter, the court endorsed the argument that the District's UDITPA statute "explicitly provides that income from property which is an integral part of the business" is business income under the functional test. Applying that test, the court found that Pierce's manufacturing plant furthered the company's business of furnishing and installing mechanical systems. Specifically, the court found that Pierce treated the facility as part of its business, deducted expenses it incurred in connection with maintaining the plant, and took depreciation deductions for wear and tear. Consequently, the court concluded that the facility was an integral part of Pierce's unitary business and ruled that insurance proceeds received as compensation for damage to the facility constituted apportionable business income.

2. In *Laurel Pipe Line Company v. Commonwealth*, 642 A.2d 472 (1994), the Supreme Court of Pennsylvania ruled that the state's "business income" statute contains both a transactional test, and an independent functional test. Laurel was an Ohio corporation engaged in transporting refined petroleum products from refinery and pipeline connections within Pennsylvania. Laurel also operated a pipeline between points in Ohio and Pennsylvania.

(a) Laurel discontinued its interstate pipeline operation and sold the pipeline assets used in that part of its business. After the sale, Laurel declared dividends in an amount equal to the after-tax net proceeds from the sale and distributed the proceeds to its stockholders. None of the

proceeds were used to acquire any asset for use in future business operations or to generate income for use in future business operations.

(b) The court first noted that due to the exceptional nature of the disposition of the pipeline assets, the gain did not constitute business income under the transactional test. Then, citing a lower court ruling that the Pennsylvania statute contains two alternative tests for classifying income, the court stated that income meets the functional test if the gain is derived from property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business.

(c) Applying that test to Laurel's disposition of pipeline assets, the court found that the pipeline assets that Laurel sold had been idle for over three years prior to their sale. The court found, in addition, that the sale proceeds were not reinvested in the operations of the business, but rather were distributed as a dividend to Laurel shareholders. Moreover, the court found, the sale of the pipeline was not necessary to maintain Laurel's "continued overall business viability." Based on these findings, the court concluded that the pipeline was not disposed of as an integral part of Laurel's trade or business.

3. The Pennsylvania Supreme Court applied these tests again in *Ross-Araco Corp. v. Commonwealth*, 674 A.2d 691 (1996) when it held that gain from the sale of unused land was not classifiable as business income under either the transactional or the functional test. Ross-Araco was a New Jersey construction company with operations in Pennsylvania. Ross-Araco acquire from its predecessor a 24.5 acre parcel of real estate in New Jersey.

(a) Ross-Araco used a building located on a fenced three-acre portion of the parcel. The remaining 21.5 acres were heavily wooded and were unimproved during Ross-Araco's 27 year ownership of the parcel. The 21.5 acre parcel was never rented, nor did it ever produce royalty income. Ross-Araco sold the undeveloped parcel for a substantial gain and invested all the proceeds in U.S. Treasury Notes.

(b) First applying the transactional test, the court found that Ross-Araco did not regularly engage in buying and selling real estate, and that the proceeds from the sale were not used for its ongoing business operations. In addition, the court found, the proceeds were not business income derived from a secondary investment business.

(c) Moreover, the court discounted the fact that Ross-Araco regularly pledged the 21.5 acre parcel as collateral to obtain performance bid bonds from insurance companies (without which Ross-Araco could not operate as a general construction contractor) because the value of the property was relatively insignificant in comparison to the total amount of the corporation's assets. As a result, the court concluded that the sale was a transaction outside the ordinary course of Ross-Araco's business and that the gain was therefore not business income under the transactional test.

(d) Next, applying the functional test, the court found that the 21.5 acre parcel was never used in Ross-Araco's construction business and that its acquisition was incidental to the purchase of the three acre tract containing a building which Ross-Araco used for storage of construction equipment. Accordingly, the court held that the property was not used to produce business income when it was held by Ross-Araco and that gain from its sale was therefore not business income under the functional test.

4. Citing these Pennsylvania decisions in *Texaco-Cities Service Pipeline Company v. McGaw*, 182 Ill.2d 262 (April 16, 1998), the Illinois Supreme Court ruled that gain from an oil company's extraordinary disposition of pipeline assets constituted business income. Texaco is a Delaware corporation headquartered in Houston, Texas. Texaco is engaged in transporting crude oil and other oil products through a network of pipelines. As part of its business, Texaco owned and operated pipelines running through several states, including Illinois.

(a) During the year at issue, Texaco sold approximately 90% of its total pipeline assets, including all of the pipeline located in Illinois. Prior to the disposition, the pipeline in Illinois had become idle and was of little operational value to Texaco. Texaco realized a substantial gain from the sale of the pipeline assets.

(b) On its return, Texaco reported the gain as allocable nonbusiness income. Because some of the pipeline assets sold were located in Illinois, Texaco allocated a portion of the gain to Illinois based on the ratio of the pipeline assets sold in Illinois to the pipeline assets sold everywhere. On audit, the Department of Revenue determined that the proceeds from the sale constituted apportionable business income under Illinois law. An administrative law judge upheld the Department's determinations.

(c) The Illinois Supreme Court agreed. Because the disposition of the pipeline assets was an extraordinary transaction, the parties agreed that the question of whether gain from the sale was business income would turn on an application of the functional test. In this regard, Texaco argued that the

gain was not apportionable business income because the disposition, a one-time transaction, was not integral to its regular trade or business.

(d) Texaco asserted that, by its terms, the functional test requires that the acquisition, management, *and disposition* must *each* constitute integral parts of the taxpayer's business. Thus, according to Texaco, the mere fact that it acquired and managed the pipeline assets as integral parts of its transportation business did not mean that their disposition yielded business income.

(e) The court rejected Texaco's interpretation of the functional test. In so doing, the court appeared to reason that in order to satisfy the functional test, the assets that are sold must simply be assets that were "used by the taxpayer in its regular trade or business operations." This reasoning does not seem persuasive. Indeed, as the three-justice dissent noted, the majority's approach virtually ignores the clear wording of the statute.

(f) The functional test explicitly requires that the acquisition, management, *and disposition* of the property at issue must constitute integral parts of the taxpayer's regular trade or business. Moreover, as the dissent also notes, the majority's ruling flatly contradicts the conclusion reached by the highest courts of several other states in their interpretations of the same functional test on essentially identical facts.

(1) The lower courts in Illinois have also found that the functional test serves as an independent, alternative standard for classifying income. For example, in *Dover Corp. v. Department of Revenue*, 648 N.E.2d 1089 (1995), the court ruled that royalties received from licensees for the use of Dover's technology in foreign markets and as a result of patent infringement recoveries constituted apportionable business income under the transactional and functional tests.

(2) Similarly in *The Kroger Co. v. Department of Revenue,* 284 Ill.App.3d 473 (1996), the appellate court again ruled that the Illinois income classification statute contains both a transactional and a functional test. *Kroger* was an Ohio corporation engaged in a retail grocery business. *Kroger* undertook a corporate restructuring program in which it closed and sold food stores and sold a drug store subsidiary. *Kroger* realized gain on the disposition of various leasehold interests sold in connection with the restructuring program. The court focused on *Kroger*'s report to the Securities and Exchange Commission as evidence that *Kroger's* restructuring plan was not an extraordinary or unusual event, but rather was a direct

outgrowth of *Kroger*'s management process. In addition, the court found that *Kroger* leased a majority of the properties used in its business. As a result, the court held that the leasehold interests were an integral part of *Kroger*'s regular trade or business operations and that gain from their sale was business income.

5. Like the courts in Pennsylvania and Illinois the Supreme Court of Oregon has also held that the state's definition of "business income" contains both a transactional test and an alternative functional test. *Simpson Timber Co. v. Department of Revenue*, 326 Or. 370 (1998). In this case, the court held that amounts received by Simpson Timber as compensation for the federal government's condemnation of its timberland and its timber was business income under the alternative functional test.

(a) In 1978, the federal government condemned 7,654 acres of Simpson's timbered property in California. Simpson received "just compensation" for the condemnation in 1988 (the tax year at issue). The government provided Simpson with $46,846,000 in just compensation as the fair market value of the condemned assets. Of that total, 91.0% was paid for the standing timber. The balance was paid for the underlying land. However, because of the 10-year delay in paying the compensation, the government also provided Simpson an additional $79,160,218 as a "compensation delay."

(b) Simpson argued that because it did not voluntarily dispose of its property or property rights, the disposition (i.e., the condemnation) could not constitute an integral part of its regular business operations. The court rejected this argument. In so doing, the court concluded that since the timber and the land on which it was growing were assets admittedly acquired and used as integral parts of Simpson's timber business, the income received from those assets, no matter how acquired, constituted business income.

6. Citing the decision in *Simpson Timber*, the Supreme Court of North Carolina reversed a ruling in which the appeals court found that the state's "business income" definition contained only a transactional test, and held that Polaroid's recovery from a patent infringement lawsuit was properly classified as business income under the alternative functional test. *Polaroid Corp. v. Offerman*, No. 70PA98 (December 4, 1998).

(a) Polaroid received a nearly one billion dollar recovery from a patent infringement suit against Eastman Kodak Company. Polaroid classified the total award from the lawsuit as allocable nonbusiness income. The

North Carolina income classification statute provides that apportionable business income is "income arising from transactions and activity in the regular course of the corporation's trade or business *and includes* income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business." N.C. Gen. Stat. Sec. 105-130.4(a)(1) (emphasis added).

(b) Focusing on the phrase "and includes" (as italicized above), the appellate court found that the phrase does not mean "in addition to." Rather, the appellate court found, the phrase means "and some examples are." Based on this determination, the court held that the statute at issue contained only one test, the transactional test. Applying the transactional test, the court found that because Polaroid is not in the business of licensing patents, the recovery from a patent infringement suit is not in the regular course of Polaroid's business, such that the acquisition, management, and/or disposition of the lawsuit damages constitute integral parts of the company's regular trade or business operations. Thus, the court concluded that the damages did not constitute apportionable business income.

(c) The Supreme Court of North Carolina reversed. In so doing, the court expressly found that the state's "business income" definition did in fact embody an alternative functional test, under which income from extraordinary transactions is apportionable so long as the relevant assets were used by the taxpayer in the regular course of business. Applying this test, the court noted that Polaroid's award consisted of "lost profits," "lost profits" determined on the basis of a "reasonable royalty" as required under federal law, and prejudgment and post-judgment interest. The court ruled that all three forms of relief constituted business income under the functional test.

7. Most recently, citing the decision in *Polaroid*, the Alabama Court of Civil Appeals has now ruled that Alabama's version of the UDITPA definition encompasses both a transactional test and a functional test. *Uniroyal Tire Co. v. State of Alabama*, CV-97-854 (May 28, 1999). On August 8, 1999, Uniroyal filed a petition for review with the Alabama Supreme Court.

(a) Uniroyal's tire division was spun off into a separate corporation in response to a hostile takeover attempt. Uniroyal accomplished the spin-off by forming a joint venture partnership with The BFGoodrich Company. Both corporations transferred the assets of their respective tire businesses to the partnership in exchange for 50% partnership interests. Uniroyal then

sold its entire partnership interest to a third party and subsequently liquidated by distributing the sale proceeds to its corporate parent.

(b) The administrative law judge began by stating his disagreement with functional test proponents that business income results if an asset sold by a taxpayer was used in the taxpayer's regular business. As the source of his disagreement, he focused on the language in the functional test which defines business income to include income from property if the acquisition, management, *and disposition* constitute integral parts of the taxpayer's business (emphasis added). He then reasoned that the use of the conjunction "and" instead of "or" requires that both the use and the disposition of the asset must occur in the normal course of the corporation's business operations.

(c) The administrative law judge observed that although corporations sometimes liquidate, they are not in business for that purpose, and liquidation cannot be said to be a normal activity of any business. Moreover, according to the administrative law judge, the MTC regulation adopted by Alabama, which provides that gain from the sale of any property used, by the taxpayer to produce business income is business income is in conflict with the language of the uniform act. Based on this construction of the uniform act, the administrative law judge ruled that Uniroyal's sale of its partnership interest did not produce apportionable business income.

(d) The court of civil appeals reversed. Citing *Polaroid*, as well as *Simpson Timber* (discussed above), the court simply noted its agreement with the opinions in those cases that the UDITPA definition contains two tests. With this as its analytical framework, the court found that Uniroyal's trade or business was its investment in the partnership. The eventual sale of that interest, the court found, was "obviously driven" by Uniroyal's desire for cash and profit and was a calculated process to maximize its return on investment. Based on this finding, the court ruled that the gain was properly characterized by the Department as apportionable business income under the functional test.

D. Legal Ruling 98-5 – Income Generated from Liquid Assets

1. In FTB Legal Ruling 98-5 (November 30, 1998), the Franchise Tax Board ruled that income generated from liquid assets in excess of the taxpayer's current and identified future business needs did not constitute business income under either the transactional test or the functional test. The taxpayer's business generated large amounts of cash, such that the taxpayer had cash in excess of its current business needs. The taxpayer had no long-term use or specific nonbusiness

uses for which the excess cash was earmarked. The excess cash was invested in liquid assets that produce interest and dividends.

2. Referring to the State Board of Equalization's decision in *Appeal of Cullinet Software, Inc.*, 95-SBE-002 (May 4, 1995), the Franchise Tax Board rejected any implication that a liquid asset produces business income merely because it has the potential to be used in the taxpayer's trade or business. Thus, the Board held, the mere holding of liquid assets in excess of current and identified future business needs cannot be considered as producing business income, despite the fact that such assets may be used in a taxpayer's trade or business.

(a) Rather, according to the Board, in determining whether an item of income meets either the transactional test or the functional test, the relevant analysis is whether the funds are needed for the taxpayer's current business cycle needs or have been earmarked for future business needs. Under this standard, the Board reasoned, to the extent that funds can be identified as in excess of any current or future business need or contingency, the functional and transactional tests set forth in section 25120 are not met.

(b) Applying this analysis, the Board found that the income at issue did not meet the transactional test in that the income clearly did not arise from "transactions or activity in the regular course of the taxpayer's trade or business." Similarly, the Board found that the income did not meet the alternative functional test in that the income was not acquired, managed, or disposed of as an integral part of the taxpayer's regular trade or business operations. For these reasons, the Board ruled that the income was clearly classifiable as nonbusiness income.

X. Sales Factor Issues

A. Occasional Sales

Most recently, the FTB staff issued a discussion draft of a proposed addition to Regulation Section 25137(c)(1)(A) which addresses special rules for the sales factor. The proposed addition provides for the exclusion from the sales factor of substantial gross receipts derived from the occasional sale of intangible assets. The draft reflects the FTB's position, as set forth in Legal Ruling 97-1, that the same rationale that applies to the current regulation's treatment of occasional sales of fixed assets applies with equal force to the occasional sale of intangibles. The rationale for the regulation is that inclusion of such gross receipts in the sales factor does not fairly reflect the taxpayer's day-to-day business activity. FTB Notice 99-3, Mar. 29, 1999.

An interesting question raised is whether FTB Notice 99-3 is a correct statement of the law, given that it is contrary to the plain reading of the statute and current regulations. In its Legal Ruling, the FTB appears to have relied exclusively on the bare authority of Section 25137. However, once the regulation becomes final, there would seem to be little doubt but that it would bind taxpayers and FTB. See *Appeal of Fluor Corporation*, 95-SBE-016, December 12, 1995, (released January 1996).

B. Electricity as Tangible Property

An interesting question faced by the power industry, in the midst of massive deregulation and, therefore, change in the way business is done, is whether electricity is tangible or intangible property. Among the issues raised by this is whether to determine the sales factor by RTC section 25134 or section 25136 (sales other than sales of tangible property), the latter requiring a costs of performance analysis.

The California Franchise Tax Board is currently considering the issue for a possible legal ruling. There is essentially no authority in California on this question. Other states that have considered the issue have not reached a uniform result. For example, *Curry v. Alabama Power Company*, 8 So.2d 521 (Ala. 1942) (the Alabama Supreme Court found electricity was tangible personal property relying on a specific Alabama statute which listed electricity as a type of tangible personal property, although the court commented that electricity has mass or weight and can be tasted, touched and smelled); *State Tax Commission v. Marcus J. Lawrence Memorial Hospital*, 495 P.2d 129 (Ariz. 1972) (electricity fell within the statutory definition of tangible personal property because it could be seen, weighed, measured, felt and touched); *Miller v. City of Los Angeles*, 197 P. 342, 343 (Cal. 1921) ("Electricity is rather an intangible asset, and the word 'property' is perhaps not the most apt word by which to describe the supply of electrical energy thus sought to be acquired for the use of the city."); *Bedford v. Colorado Fuel & Iron*, 81 P.2d 752, 756 (Colo. 1938) ("While this section exempts gas and electricity, which might be considered as not being tangible personal property…"); *Farrand Coal Co. V. Halpin*, 140 N.E.2d 698, 701 (Ill. 1957) ("Although this court recognizes electricity as personal property, it has at no time held electricity to be 'tangible personal property'"); *In re Collingwood Grain, Inc.* 891 P.2d 422, 427 (Kan. 1995) ("It is undisputed that electricity is "tangible personal property" subject to the sales tax exemption" citing K.S.A. 79-3602(m)(B)); *Sommers v. Secretary*, 593 So.2d 689(La. 1992) (electricity is tangible personal property and therefore subject to sales tax); *Omaha Pub. Power Dist. V. Nebraska Dept. Of Revenue*, 248 Neb. 518 (1995) (the generation of electricity was held not to be the manufacture of tangible personal property); *Aldine Apts. V. Commonwealth*, 379 A.2d 333 (Commonwealth Court, Pa. 1977) (electricity was statutorily exempted from the definition of tangible personal property); *Texas Eastern Transmission Corp. V. Benson*, 480 S.W.2d 905 (Tenn. 1972) (electricity is a taxable item of tangible personal property).

If electricity is tangible property in California, then the apportionment and taxability rules for tangible personal property would appear to apply, including P.L. 86-272, and Section 25135, Rev. and Tax. Code. If the FTB adopts a formal position that electricity is tangible personal property, there are some interesting double taxation possibilities in light of the holding in *McDonnell Douglas Corporation v. Franchise Tax Board*, 26 CA4th 1789, 26 CA4th 808, 31 CRptr2d 712, modified August 8, 1994 (1994).

McDonnell Douglas, an aircraft manufacturer, was permitted to exclude from the California sales factor numerator of the apportionment formula its sales of aircraft that were destined for use outside California but that were delivered to purchasers in California. The court declined to follow California CCR Sec. 25135 and FTB Legal Ruling 348 under which property was considered to be delivered or shipped to a purchaser within California and includible in the California sales factor numerator if the shipment terminated in California or the purchaser took possession of the property in California, even if the property was subsequently transferred by the purchaser to another state. The court found the letter ruling and the regulation to be in contradiction with case law in other jurisdictions as well as the primary purpose of UDITPA, which is to ensure uniformity among the states. UDITPA has been interpreted to provide that "sales of tangible personal property should be apportioned to the state or county of destination, provided the taxpayer is subject to tax in such state or country".

Comment: Near the California/Oregon border, but well on the Oregon side there is a power grid referred to as "COB." Were a California purchaser to take delivery at COB, intending to "ship" the power to California for customers there, Oregon might take the position that the destination of the sale was Oregon, and California, under *McDonnell Douglas*, might take the position that the sales should appear in the California numerator since the ultimate destination was California. Oregon might alternatively consider the sale of electricity as intangible property, which would assign the sale to Oregon on the basis that the greater cost of performance is in that state.

XI. Variations from the Standard Formula

A. UDITPA, reflected in California in Section 25137, Rev. and Tax Code, provides that if the allocation and apportionment provisions of the Act "do not fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for or the Franchise Tax Board may require" any other method that effectuates an equitable allocation and apportionment of the taxpayer's income.

B. *Hyundai Motor America*

A marketing and product sales was held to be instantly unitary with its Korean

parent, Hyundai Motor Company (HMC). Preparatory steps taken by HMC to perfect a vehicle that would capture the American market were arduous, detailed and date back to as early as 1977 and HMC orchestrated its grand entry into the United States by incorporating appellant on April 26, 1985. There was an immediate integration of the entities which plans had been formulated beginning years earlier and an immediate infusion of capital by HMC. These factors are among those establishing a pre-existing relationship and evidence that the entities were instantly unitary. However, distortion was found to result from forced combination because the U.S. subsidiary had no income in the first year (in fact incurred substantial losses) and thus separate accounting was permitted. This is the first time any of the panelists is aware that separate accounting has been permitted as a remedy under RTC 25137. *Appeal of Hyundai Motor America*, Cal. SBE, No. 97A-0310, June 25, 1998, *rehearing denied*, Jan. 9, 1999 (summary decision, not to be cited as precedent).

C. *Unisys Corporation v. Commonwealth of Pennsylvania*

1. The Pennsylvania Commonwealth Court on March 8, 1999 granted Unisys Corporation equitable relief because the franchise tax base was computed on a consolidated basis while the apportionment factors assigning a portion of the base to the Commonwealth were constructed on a separate company basis. No. 151 F.R. 1991; No. 201 F.R. 1993 and no. 202 F.R. 1993.

2. The Pennsylvania Franchise tax is imposed on the capital stock value of every out-of-state corporation doing business in the Commonwealth. The tax is designed to tax only the business activity conducted in the Commonwealth.

(a) A reporting corporation calculates its capital stock value by a statutory formula based on net worth. The calculation contains two parts. The first portion of the calculation includes the net worth of any entity in which the corporation owns common stock. The second portion of the calculation is the average of the last five years' net income including dividends received from the investee corporations.

(b) After computing the base a corporation must arrive at a taxable value by applying an apportionment factor to the actual value. The Code sets forth two methods for apportioning value; a single factor method and the use of the standard three-factor apportionment formula. The three factor method consists of the average of three factions consisting of the ratio of instate property, payroll and receipts to total property, payroll and receipts.

3. Unisys owned either directly or indirectly the stock of more than 100 domestic and foreign corporations. The Department included the value of Unisys's investments and the dividends received from those investments in its franchise tax

base. However, the Department apportioned the base using Unisys' separate company factors.

4. Unisys argued that the Commerce and Due Process Clauses of the U.S. Constitution require the Commonwealth to included the property, payroll and sales of its affiliates in the apportionment formula. To exclude such items from the computation is fundamentally unfair. In the alternative, Unisys argued that it was entitled to statutory equitable relief under the special apportionment provisions of Section 401 (3) 2.(a) (18) of the Tax Code. (Section 18 of UDITPA).

5. The Commonwealth Court rejected Unisys's constitutional claims. In so doing the court analyzed the result in light of the internal and external consistency tests set forth by the U.S. Supreme Court. concluding that Unisys had not met its burden of showing that the value attributed to the Commonwealth was out of all appropriate proportions to the business transacted in the Commonwealth. The distortion levels did not reach those found by the Court *in Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931) or *Norfolk &W. Ry. Co. v. Missouri State Tax Commission*, 390 U.S. 317 (1968).

6. Although the court concluded that the 44.5% disparity did not rise to the level of constitutional proportions it did find that the Department abused its discretion in refusing to adjust Unisys' allocation share under Section 18. The Commonwealth Court held that it does not matter "whether the formula allocates a large or small share of the business to the Commonwealth but how far that share varies from the actual share."

7. The Commonwealth Court pointed out that each case must be decided on its own merits and Section 18 relief may not be granted in all cases. Further, the court went on to conclude that the remedy sought by Unisys, *i.e*., inclusion of the subsidiaries' data in the three factor formula, is mandated. It is however, a sensible approach.